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SUBJECT: Have You Heard? China Slashes VAT Refunds

¶1. (SBU) Summary: What's the impact on local companies in the region of the July 1 cut/elimination of export tax rebates on almost 3,000 products? Local companies are unanimous: the price of most goods imported from China just went up. Even so, foreign-invested enterprises (FIEs) here are not cutting back on operations -- and a lucky few might even find that their situations have improved. Still, there is some debate over whether the move will give local companies an increased competitive advantage, as they may now have yet another tax to evade, while their FIE counterparts are left to pay in full. At least one consultant has begun counseling clients that while they can not be sure when it will occur, they can count on some type of ongoing VAT changes, and they should prepare accordingly. End Summary.

Export Rebates Slashed Across the Board

¶2. (SBU) China earlier this month quietly took a dramatic step toward slowing down its soaring export industry. On July 1, Beijing cut the tax rebates for exports on more than 2,200 products, and eliminated the rebates entirely on another 553 products. The latter primarily targeted high-energy-consuming and polluting products, while the former focused on low-tech commodities likely to trigger trade disputes.

¶3. (SBU) The move affects U.S. business across the board said import consultant Eli Ben-Avner. Additionally, since the new policy is not covered by any transitional rule which would allow existing contracts to continue operating under the old VAT rebate, the impact has been immediate.

¶4. (SBU) The new refund policy does allow an exception for contracts covering the export of ships and building materials in long-term construction projects, where the contracts were signed before July
¶1. This has helped companies like BCD, Inc. avoid liability for the added costs of long-term building projects under the new VAT export policy. COMMENT: This exception may also potentially explain why there was little warning given to companies prior to the VAT reform (See paragraph 9, below), as the government may have not wanted to offer companies in this industry a chance to lock in numerous long-term contracts which could evade the new tax policy. END COMMENT.

Motivations behind the Change

¶5. (SBU) There are various opinions circulating about what motivated the sudden change to China's VAT refund structure. According to Aaron Finley, Manager of Deloitte in Guangzhou, the move was primarily driven by economics. Finley believes the new policy is a reflection of the country's desire to encourage more companies to invest locally by selling to local markets. Even more importantly, the products targeted by the new policy make it clear that China is stepping up its efforts to curb production of low-tech goods and discouraging altogether the production of chemical and energy products which either cut into the country's scarce natural

resources or harm the local environment. As the new head of the Guangdong Overseas Businessmen Association, Zhou Zerong, recently told us, low-tech companies are not actively discouraged, but just don't enjoy the favorable conditions provided to technology and market-leading firms.

¶6. (SBU) Some believe the change was driven by politics. According to Vivian Desmonts, Managing Partner for South China's leading European law firm, DS Law Firm, the move may have been triggered as a response to the persistent lobbying by the U.S. and Europe on China's currency reform and expanding trade surplus. By penalizing U.S. and European investment, Desmonts believes that China is sending a clear message that it has no problem complying with requests to cool down exports, particularly in areas where FIEs will absorb the worst of the blow. (COMMENT: we think the real motive is economic, but certainly don't discount the possibility that the Chinese might see an opportunity to signal displeasure over U.S. efforts to get their attention on issues of importance to us. END COMMENT.)

Price Already Being Passed on to Consumers

¶7. (SBU) According to Deloitte's Finley, suppliers throughout South China have already begun restructuring their contracts to pass the entire refund adjustment on to the consumer. In fact, David Lee, Director of the China office of one of America's largest hardware companies, Ultra Hardware, has stated that among his fifty factory suppliers in South China, only six have been willing to share some of the increased cost. As a result, while the company still plans on sourcing from the region, it has already begun negotiating with suppliers in Vietnam and Cambodia, which may now be able to offer lower prices.

Investment Not Expected To Leave. . . Yet

¶8. (SBU) Consensus among business professionals is that the recent VAT reform will not drive away most foreign investment. According to Maarten Roos, Legal Consultant for local law firm Wang Jing & Co., there are simply too many other reasons for FIEs to stay. However, Roos does acknowledge that the long-term effect will be to shift some investment to areas like Laos, Vietnam and Thailand, where some products may be sourced at a lower cost.

¶9. (SBU) This sentiment was echoed by Finley, who added that the biggest complaint among FIEs in the region was not the change in the policy itself, but rather the abruptness with which it occurred. No companies were made aware of the change earlier than one week prior its issuance. In fact, even local customs officials were caught off-guard by the restructuring, as the new policy evidently sparked a flurry of confused activity in the ports regarding how to implement the newly-established export tax refund system.

¶10. (SBU) If the changes in VAT do have an adverse impact on foreign investment anywhere, it is likely to be in South China, where most manufacturing investment takes place. Moreover, since large FIEs in the region typically produce for sale to the China market, the brunt of this is expected to fall on small to medium-sized enterprises (SMEs), which engage almost exclusively in export-oriented production.

No Refund, No Problem

¶11. (SBU) The sweeping VAT reform has hurt most exporters in the region, but a select few may actually experience improvements in their tax status. As Finley explains, companies which previously exported a single product input may now stand to profit by exporting the entire product. For instance, instead of exporting the copper fitting used in the production of a chair (which is now subject to a reduced VAT refund), some companies may now choose to design and export the entire chair - a practice which would result in a zero percent export VAT, thus nullifying the need for any refund. In

such cases, companies will need to move assembly productions to China. However, the impact on the U.S. job market is expected to be small, with Mexico and other labor-intensive economies bearing the brunt of such a policy.

Concerns of Discriminatory Treatment

¶12. (SBU) Some of our contacts have expressed concern that the VAT change will add yet another layer of competitive disadvantage to FIEs. As Dan Harris, Managing Partner for Harris & Moure puts forth, taxes tend to be paid primarily by law-abiding foreign companies, thus increasing the competitive advantage of Chinese companies. Therefore, if a foreign company is paying a 17 percent tax on its exports from China (as will be paid by all companies whose VAT refund was completely removed) and a Chinese company making the same product is paying only five percent or less (or trying to avoid payments altogether), the Chinese company would immediately gain a large cost advantage that should allow it to sell and export more products than its foreign competitor.

¶13. (SBU) There are some experts, however, who are not ready to endorse this concern. According to Finley, large U.S. companies play by the book in most cases, since their exposure would simply be too great if they chose to do otherwise. However, Finley said that numerous unlisted FIEs in the region are still pushing the envelope, and thus he warns that it may not only be local companies that are evading taxes. Finley believes this perception has been mistakenly driven by the fact that the tax bureau targets individual foreigners because they are in a high income group, a practice which he says does not translate to business tax investigations, as those are categorized by industry, not income.

More Changes on the Way

¶14. (SBU) Much of the business community was caught off-guard by the recent widespread reduction in VAT refunds, so much so that some have already begun to make preparations for the next round of changes. Aroma Housewares' Purchasing Supervisor Lisa Huang told us that speculation about other possible changes in the VAT for additional products has led many in the small appliance industry to delay signing long-term contracts for fear that they will be left holding the bag when the other shoe drops. Deloitte has also begun counseling clients that while they can not be sure when it will occur, they can count on some type of ongoing VAT changes, and whether it means re-designing production or leaving the region altogether, they should prepare accordingly.

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